Internal Revenue Service
memorandum

CC:TL-N-9114-91
FS:CORP:GBFleming

date: NOV 4 1991

to: District Counsel, Denver SW:DEN
Attention: Virginia Draper

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted]

This responds to your memorandum dated July 31, 1991, requesting tax litigation advice with respect to the above-captioned case.

ISSUES

1. Can the Service make a case that [redacted] is not entitled to report the excess loss account under Treas. Reg. § 1.1502-19 as capital gains, but rather must recognize the recapture as ordinary income because [redacted] was insolvent?

2. Is the position that [redacted] is not entitled to take any of the losses stemming from its acquisition of [redacted] because it was acquired for the principal purpose of obtaining losses strong enough to litigate the issue?

3. Was [redacted] able to avoid gain on the acquisition of the building by the bank in [redacted] by making a section 338 election?

4. If the case should go to litigation, can the corporate and TEFRA partnership issues be combined in one case, given that all partners in the TEFRA partnership action are parties to the suit?

DISCUSSION

The extensive facts involved in this case, as set forth in the defense letters and the government's brief (Attachments 1-5 to your memorandum), are incorporated by reference and will not be recited in full. The facts relevant to your request will be described briefly under the discussion of each issue.

I. Excess Loss Account

This issue concerns the character of the income that [redacted] included under Treas. Reg. § 1.1502-19 from the excess loss account (ELA) with respect to the stock of [redacted]. [1] The general rule under Treas. Reg. § 1.1502-19(a)(2)(i) is that the amount of the ELA is treated as gain from the sale of stock, which in most cases is capital gain. An exception to this general rule, however, is provided in Treas. Reg. § 1.1502-19(a)(2)(ii) if the subsidiary the stock of which is disposed of is insolvent at the time of the disposition. In such a case, the income from the ELA is treated as ordinary income *to the extent of the subsidiary's insolvency*. [2] Thus, in the instant case, if [redacted] was insolvent at the time it left the [redacted] group, [redacted] must treat the ELA as ordinary income to the extent of [redacted]'s insolvency.

According to the information that you have provided, [redacted] reported the ELA on the return for its taxable year ending [redacted] in the amount of $[redacted], treating that entire amount as capital gain. We understand that [redacted] arrived at the ELA by starting with [redacted]'s capital account of approximately $[redacted] and subtracting approximately $[redacted] for partnership deductions attributable to the period after [redacted], the date on which [redacted] sold its [redacted] stock to [redacted]. As a result of the partnership audit of [redacted], the Service disallowed approximately $[redacted] of partnership deductions taken by [redacted]. You have indicated that for purposes of settlement [redacted] will agree to a reduction of $[redacted], which would reduce the amount of the ELA to approximately $[redacted]. [3]

You have asked us to give advice on whether [redacted] was insolvent. The relevant time for determining insolvency for purposes of an ELA is the date on which the ELA is triggered. In this case, the ELA was triggered when the [redacted] stock was sold to [redacted].

We have received from you a computation concerning [redacted]'s insolvency, which begins with [redacted]'s capital account in [redacted] and makes several adjustments thereto to arrive at an "adjusted insolvency" of approximately $[redacted]

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[1] [redacted] wholly owned subsidiary [redacted] held [redacted] percent of the stock of [redacted] Upon [redacted] sale of the stock of [redacted] to [redacted], [redacted] ceased to be a member of the [redacted] consolidated group, and [redacted] was required by Treas. Reg. § 1.1502-19(a)(1) to include in income [redacted]'s ELA with respect to [redacted].

[2] The insolvency exception to capital gains treatment of the ELA does not apply to the extent that the taxpayer can establish that the ordinary income portion of the ELA is attributable to losses of the subsidiary which reduced long term capital gains of the consolidated group (without regard to section 1201). Treas. Reg. § 1.1502-19(a)(ii)(*c*). We assume that none of the partnership losses taken by [redacted] reduced the long term capital gains of the [redacted] group.

[3] The ELA could be further reduced if the Service prevails, or if [redacted] were to agree to scale down the deductions it took from [redacted] based on other potential arguments such as the section 269 issue or the *Spreckels* issue discussed below. Assuming the IRS can show insolvency of $[redacted], any scaledown of the [redacted] losses deducted by [redacted] from $[redacted] down to $[redacted] will have the net effect of converting ordinary deductions to capital losses. [Note that a triggered ELA produces ordinary income only to the extent of the subsidiary's insolvency, which in this case appears to be between $[redacted] and $[redacted].] To illustrate: if an additional $[redacted] of partnership deductions were denied to [redacted] its ELA would also be reduced by $[redacted]. Hence, [redacted] would have $[redacted] less in capital gains when the ELA is triggered. The net effect to [redacted] would be that it would lose $[redacted] dollars of ordinary deductions and receive, in effect, a $[redacted] capital loss (*i.e.*, it would have $[redacted] less in capital gains).

[redacted]. We understand this computation was prepared by [redacted] for settlement purposes and that [redacted] is willing to agree to an insolvency of $[redacted] as part of a settlement.

The question of [redacted]'s insolvency is a factual, economic determination involving a comparison of its liabilities (as described in Treas. Reg. § 1.1502-19(a)(ii)) against the fair market value of its assets. Whether the $[redacted] figure in [redacted] calculation approximates the figure that would be produced if liabilities were subtracted from assets is a question we cannot answer without more facts. However, it appears that [redacted] is willing to concede the higher $[redacted] insolvency amount.

If you do not believe that a comparison of assets and liabilities would necessarily show a greater (or lesser) figure than [redacted] has agreed to concede, perhaps [redacted] concession on this issue should be accepted. If you do obtain the asset and liability figures necessary to make the insolvency calculation, we will be glad to give you our comments on what the level of insolvency is. Furthermore, if we can be of any assistance to you in working with taxpayer to develop the assets and liabilities data, should you choose to pursue this, we will be glad to help.

II. Section 269 Issue

You propose to assert that section 269 precludes [redacted] from using [redacted]'s allocable share of the losses generated by [redacted]. You believe that the acquisition by the [redacted] consolidated group of control of the stock of [redacted] was principally for the purpose of obtaining the above partnership deductions and had no other economic effect. That is, as soon as the [redacted] group used up the losses, it sold the [redacted] stock back to [redacted] for nominal consideration, pursuant to prior agreement. The [redacted] group, in effect, paid about $[redacted] for the use of approximately $[redacted] of partnership deductions. [redacted] claims that it had a business purpose because it was a contractor working on the construction of the building being built by [redacted] and entered into this deal to support its construction business. In other words, [redacted] contends that its contribution of $[redacted] to the partnership constructing the building prevented termination of the building project and, in turn, protected its business interests as a major contractor on the project. The $[redacted] million that [redacted] contributed, however, was a payment for using the partnership deductions by acquiring the stock of [redacted].

You have asked us whether this section 269 argument can be maintained, especially in light of Technical Advice Memorandum (TAM) 9134003 (May 6, 1991). The TAM states, in part, that one factor establishing that section 269 does not apply in that case is the determination that the acquisition of a partnership interest could just as easily have yielded the same desired tax benefits as the acquisition of control of a corporation. [redacted] argues that this TAM supports the nonapplicability of section 269 in this case because it could have obtained the same tax benefits it obtained from [redacted] by acquiring instead a partnership interest in [redacted]

We have a number of comments on this issue. First, we recommend that you consider making a non-section 269 attack on [redacted] use of the partnership deductions. In *J.D. & A.B. Spreckels Co. v. Commissioner*, 41 BTA 370 (1940), the Board of Tax Appeals held that a corporation was not a member of an affiliated group because the taxpayer's ownership of the corporation's stock did not serve a business purpose, as distinguished from a tax-reducing purpose. We suggest that you determine whether the facts in the instant case are sufficiently close to those in *Spreckels* to come within the rationale of that case, which if applicable would preclude the [redacted] group from using the partnership deductions.

Second, we believe an argument can be made under section 269 even if [redacted] can demonstrate that an acquisition of a partnership interest instead of control of [redacted] would have given it the same tax benefits as its acquisition of [redacted] can point out that section 269 requires that control of a corporation (here [redacted]) be acquired and that acquisition of control be for the principal purpose of obtaining tax benefits that it *would not have obtained without obtaining that control*. It may then argue that it did not obtain any tax benefit via control of [redacted] that it could not have obtained through acquisition of a partnership interest in [redacted]. In other words, [redacted] argument is that since it could have obtained the same tax benefits if it had acquired a partnership interest, its acquisition of control of [redacted] could not have been for a principal purpose of securing a tax benefit that it could not otherwise have obtained. [redacted] relies on TAM 9134003, discussed above, to support its argument that section 269 is not applicable in this case.

We believe the following arguments can be made under the language of section 269. First, depending on the facts, we could argue that practical difficulties would have made it impossible to utilize a partnership to obtain the same tax benefits. We do not have sufficient facts to determine the correctness of taxpayer's assertion that it could have obtained the same tax benefits by acquiring a partnership interest rather than control of [redacted]. You may wish to request that taxpayer provide the details and supporting facts to justify its assertion. If you need our assistance in dealing with taxpayer on this matter, we will be glad to help. Once you have obtained these details, we would also be happy to give you our comments on taxpayer's assertion at that time.

Second, we can also argue that a principal purpose of [redacted] acquisition of the stock of [redacted] was to obtain deductions that it did not previously have. Since it acquired control of [redacted] in order to get tax benefits that it did not previously have, it comes within the ambit of section 269. Even if [redacted] could have obtained those same deductions by structuring a transaction that would not have met the trigger events of section 269, it did not do so. The TAM can be distinguished since the transaction there had a valid business purpose and was not abusive. For that reason, the fact that the taxpayer in the TAM could have accomplished the transaction without implicating the section 269 trigger events could be accorded greater significance in the TAM than in the [redacted] transaction. In contrast, the transaction in [redacted] would be devoid of economic substance in any event, irrespective of whether [redacted] acquired control of the stock of [redacted] or direct ownership of an interest in [redacted], since [redacted] did not stand to receive any economic benefit from its ownership of [redacted].

For similar reasons, we believe that the Action on Decision (AOD) acquiescing in *Cromwell Corp. v. Commissioner*, 43 T.C. 313 (1964), is also distinguishable. In *Cromwell*, the Service denied the privilege of filing a consolidated return based on section 269, arguing that the formation of Cromwell and its subsequent acquisition of an operating company were for the principal purpose of securing a tax benefit which could not otherwise have been obtained. The benefit at issue was the exclusion of a dividend from the operating company to Cromwell, which Cromwell then used to pay off a bank loan obtained to purchase the operating company. In effect, the dividend exclusion within the consolidated group allowed Cromwell to use the operating company's assets to finance the acquisition. Finding that the same benefit could have been obtained by using alternative methods, the Tax Court held that section 269 was inapplicable. In recommending acquiescence, the *Cromwell* AOD states that "the issue is in part factual . . . and the Court's application of the narrow statutory phrase involved is reasonable." (A copy of the AOD is attached.)

Although not expressly noted in the AOD, the Tax Court observed that "the basic purpose of section is to prevent the distortion of a taxpayer's net income" and that there was no distortion of income in this case. 43 T.C. at 320. The court further distinguished the transaction in *Cromwell* from "the usual section 269 situation where a taxpayer is attempting to secure the benefit of built-in tax advantages, typically a net operating loss carryover, by combining two corporations via an acquisition." *Id.* Thus, as in the TAM, there was not the abuse that exists in the instant case.

Insofar as [redacted]' argument that support of its construction business provides sufficient business purpose to preclude application of section 269, we believe that in a situation where the buyer of stock, such as [redacted], cannot under any circumstances directly profit from its investment in the acquired stock due to an agreement to resell that stock for nominal value, the fact that the purchaser may obtain an indirect benefit (such as support of its construction business) in addition to a huge tax benefit for which it made a tax benefit payment of over $[redacted] does not preclude application of section 269.

III. [redacted]'s Tax Consequences on Foreclosure of the [redacted] Business

[redacted] did not report any income on its final return even though the [redacted]'s building was transferred to creditors. You believe that may have been incorrect and could have a bearing on the issue of the degree of insolvency of [redacted] at the time its stock was sold by [redacted] to [redacted] triggering the [redacted] ELA.

You have asked if we have any comments on this matter. We do not have sufficient facts to be able to provide any meaningful comments. However, you may wish to request from [redacted] and/or [redacted] a detailed computation plus supporting facts showing whether and to what extent, if any, [redacted] had any reportable income generated by the transfer by [redacted] of its building to creditors. Matters that could be relevant to this computation are:

1) What were the original contributions to [redacted]?

2) What later events affected [redacted]'s basis in the building or its amount realized at the time of the transfer of the building to creditors?

3) What was [redacted]'s basis in its partnership interest in [redacted] originally and up to the time it transferred its partnership interest to [redacted]?

4) What was [redacted]'s basis in the [redacted] originally and what later events affected that basis up to the time of the transfer of the building to creditors?

5) What was [redacted]'s basis in its [redacted] interest initially?

6) Did [redacted] acquisition of [redacted] qualify under section 338 and, if so, what was the section 338 basis of [redacted]'s partnership interest in the [redacted] (*i.e.*, [redacted]'s only asset)?

7) What other adjustments should be made to [redacted]'s basis in its [redacted] interest up until the date the building was transferred to creditors?

If you decide to develop the facts concerning the above, we would be willing to assist you in dealing with [redacted] or [redacted] in connection with the development of these facts. We would also be willing to comment on the tax consequences to [redacted] once the facts have been developed.

IV. Litigation of the Corporate and TEFRA Partnership Issues

You have asked whether (non-TEFRA) corporate issues and TEFRA partnership issues can be "combined" in one proceeding for litigation purposes.

Two previous technical advice memoranda for this case (dated [redacted], and [redacted]) addressed whether certain issues could be raised in the TEFRA partnership proceeding and concluded that they could not because they were not partnership items. However, those technical advice memoranda did not address whether a TEFRA partnership proceeding and a non-TEFRA proceeding can be consolidated for litigation purposes. We have concluded that in the situation where two notices (the FPAA and the protective position statutory notice) have been petitioned and the Court has valid jurisdiction over each issue in the proceedings, then such proceedings can be combined for purposes of litigation. It is unclear, however, from the incoming request whether a complaint has been filed for the non-TEFRA issues in the instant case.

The underlying suit here is a petition from an FPAA and was filed in the District of Colorado pursuant to I.R.C. § 6226(a)(2) on behalf of the [redacted]. Subsequently, the IRS issued [redacted], the parent corporation of one of the partners in [redacted], a protective statutory notice making adjustments to nonpartnership items. That notice was dated [redacted]. It is our understanding based upon prior discussions with your office that the statutory notice was defaulted. The notice did not raise the section 269 issue, which was the central subject of the two previous technical advice memoranda. The following analysis assumes that it is understood that the District Court could have jurisdiction over the "corporate issues" only if [redacted] had defaulted the petition, paid the deficiency, filed a claim for refund, had the claim denied or unanswered for six months, and then filed suit for refund. Your memorandum does not indicate whether any of these basic jurisdictional facts have been satisfied.

As stated in the earlier technical advice memoranda, only partnership items can be addressed in a partnership proceeding. The court's jurisdiction to determine partnership adjustments derives from section 6226, while the court's jurisdiction for determining non-TEFRA adjustments falls under the subchapter B procedures. Thus, TEFRA partnership issues and non-TEFRA corporate issues cannot be combined based solely upon the filing of the petition from the notice of FPAA and a defaulted statutory notice.

Your incoming request suggests that our conclusion regarding whether non-TEFRA issues can be raised in a TEFRA proceeding may be different if we consider the fact that all the partners in the TEFRA proceeding are parties to the suit. That fact has no impact on our conclusion. The issue here is whether the court has jurisdiction over non-TEFRA issues in a TEFRA proceeding based upon a notice of FPAA. The fact that the parties to the partnership proceeding would be the same parties in the non-TEFRA proceeding does not bestow jurisdiction upon the court for the non-TEFRA issues. If the only complaint filed is based upon the notice of FPAA, the court has jurisdiction only over the partnership items and does not have jurisdiction over the nonpartnership items.

On the other hand, if two separate complaints have been filed -- one based upon a denial of a claim for refund and the other based upon the notice of FPAA -- the court validly has jurisdiction over all of the issues in these separate respective proceedings. Because the court has jurisdiction over each, we see no reason why the two separate proceedings could not be combined for purposes of litigation (*i.e.*, trial), particularly since the same parties are involved and the issues arise from the same facts and transactions.

Based upon facts in the earlier technical advice memoranda, it does not appear that [redacted] has petitioned the court from the protective position statutory notice. If [redacted] had petitioned, then no consolidation could take place because this petition would have been in the Tax Court.

If a complaint has been filed or is later filed in the District Court, then consolidation may be possible for the issues raised in that notice. However, it is unlikely that consolidation could occur for the section 269 issue. Since that issue is an affected item, the partnership proceeding probably must be completed before it can be litigated. Furthermore, the issue is not before the court even if a complaint based upon the defaulted statutory notice has been filed because the section 269 issue was not raised in that notice and no tax on this issue can possibly have been paid yet, much less refunded.

We want to emphasize that it is the fact that valid petitions have been filed for the TEFRA and non-TEFRA issues which allows for the consolidation, and not the fact that all the partners in the TEFRA proceeding are parties to the suit. In the previous technical advice memoranda for this case, we looked at the possibility of raising non-TEFRA issues in a TEFRA partnership proceeding, not at consolidating two proceedings where the court has jurisdiction over the issues. The Tax Court has held that partnership items and nonpartnership, or affected, items cannot be raised in the same proceeding. *See Trost v. Commissioner*, 95 T.C. 560 (1990); *N.C.F. Energy v. Commissioner*, 89 T.C. 741 (1987); *Maxwell v. Commissioner*, 87 T.C. 783 (1986); *Farris v. Commissioner*, T.C. Memo. 1986-567. However, these cases have involved the situation where only one notice, either an FPAA or a statutory notice, was issued and petitioned. They do not involve the situation where an FPAA and statutory notice were issued and both petitioned, and taxpayers were attempting to consolidate for purposes of trial.

If you have any further questions, please call Gerald Fleming at FTS 566-3335 concerning issues I through III, or Marsha Keyes at FTS 566-4174 concerning issue IV.

DANIEL J. WILES

By: ALFRED C. BISHOP, JR.
Chief, Corporate Branch
Field Service Division

Attachment:
Cromwell AOD